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UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

In re **VALLEY HEALTH SYSTEM, a California Local Health Care District,** **Debtor.**	**Case No. EDCV 10-00730-SVW** **Bankr. Case No. 6:07-bk-18293-PC** **Adv. Proc. No. 6:09-ap-01708-PC** **APPELLANTS' OPENING BRIEF**
PRIME HEALTHCARE MANAGEMENT, INC., a California corporation; ALBERT L. LEWIS, JR., a taxpayer and resident of the VHS local health care district; JOHN LLOYD, a taxpayer and resident of the VHS local health care district; EDWARD J. FAZEKAS, a taxpayer and resident of the VHS local health care district, **Appellants** **v.** **VALLEY HEALTH SYSTEM, a California local health care district** **Appellee,** **PHYSICIANS FOR HEALTHY HOSPITALS, INC., a California Corporation** **Real Party in Interest.**	

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I

INTRODUCTION

On April 26, 2010, the Bankruptcy Court entered an order confirming Valley Health System's (the "Debtor") First Amended Plan for Adjustment (the "Confirmation Order"). Debtor's First Amended Plan for Adjustment ("Debtor's Plan) is predicated on Debtor selling substantially all of its assets to Physicians for Healthy Hospitals, Inc. (PHH) pursuant to the terms of an Asset Sale Agreement (the "ASA") which was approved by Debtor's Board of Directors on October 6, 2009. The Confirmation Order should be reversed because: (1) Debtor's Plan is only feasible if the ASA is not void under California Government Code § 1092 ("Section 1092"); (2) the ASA is void under Section 1092 because at least three members of Debtor's Board of Directors were financially interested in the ASA and thus prohibited from voting on the ASA by California Government Code § 1090 ("Section 1090); (3) despite being prohibited from doing so, three members of Debtor's Board of Directors voted to approve the ASA such that the ASA is void under Section 1092; and (4) since the ASA is void, Debtor's Plan is not feasible.

First, Debtor's Plan is predicated on the sale of all of its assets pursuant to the ASA and as such, is only feasible if the ASA is not void under Section 1092.

Second, every contract made in violation of Section 1090 is void under Section 1092. The ASA was made in violation of Section 1090 and is thus void under Section 1092 because at least three members of Debtor's Board of Directors, William H. Cherry, M.D. ("Cherry"), Vinay Rao ("Rao"), and Madaleine Drier ("Drier"), were prohibited by Section 1090 from voting on the ASA. Cherry and Drier were financially interested in the ASA because they had financial relationships with Hemet Community Medical Group ("HCMG") and KM Strategic Management ("KM Management") and both of these entities had a

financial interest in the ASA. Furthermore, Cherry, Rao, and Drier were financially interest in the ASA because the sponsors of the ASA, Chaudhuri and PHH, had the ability to affect the fortunes of Cherry, Rao, and Drier.

Third, despite being prohibited from doing so by Section 1090, Cherry, Rao, and Drier all voted to approve the ASA on October 6, 2009. As such, the ASA is void under Section 1092.

Finally, since the ASA was and is void under Section 1092, Debtor's Plan is not feasible.

II

JURISDICTIONAL STATEMENT

This Court has jurisdiction over this appeal from the Bankruptcy Court's April 26, 2010 Order (i) Confirming First Amended Plan for Adjustment Of Debts Of Valley Health System Dated December 17, 2009, As Modified February 19, 2010, And (ii) Granting Judgment For Valley Health System In Each Challenge Action pursuant to 28 U.S.C. § 158(a).

III

STATEMENT OF ISSUES

Pursuant to Federal Rules of Bankruptcy Procedure 8006, Appellants identified numerous issues to be presented on appeal with regard to the Confirmation Order. (DN 75[1]). These issues all relate to one main issue and a number of sub or related issues[2]:

(1) Whether the Bankruptcy Court erred in entering the Confirmation Order.

(a) Whether the Bankruptcy Court erred in entering the Confirmation Order by ruling that judgment in each of the Challenge Actions, as described in the Court's Memorandum Decision filed and entered on April 8, 2010 was granted in favor of Debtor;

(b) Whether the Bankruptcy Court erred in entering the Confirmation Order by ruling that judgment in each of the Challenge Actions, as described in the Memorandum Decision, was granted in favor of the Debtor, by ruling that the Plan was feasible; and

(c) Whether the Bankruptcy Court erred in entering the Confirmation Order by ruling that judgment in each of the Challenge Actions, as described in the Memorandum Decision, was granted in favor of the Debtor, by ruling that no member of the Debtor's Board of Directors violated Section 1090 of the California Government Code when the Board approved the sale of the Debtor's assets to Physicians for Healthy Hospitals.

[1] "DN" refers to the Docket Number in Adversary Proceeding Number 6:09-ap-01708-PC.

[2] Appellants have elected to not pursue appeal of those issues identified as Issues Nos. 2, 3, 4, 5, 6, 9, 11, 12, and 13 in their Statement of Issues on Appeal and instead will focus their appeal on the issues set forth above.

IV

STATEMENT OF FACTS AND CASE

A. The Parties

Valley Health System ("Debtor") is a California Local Health Care District which at all times relevant to this appeal owned and operated Hemet Valley Medical Center, a 340 bed acute care hospital in Hemet, California, and Menifee Valley Medical Center, a 84 bed acute care hospital in Sun City, California. (DN 68, p. 3:12-13, 4:1-8.)

Appellant Prime Healthcare Services, Inc., is a Delaware corporation that, by and through its subsidiaries, operates twelve (12) acute care throughout California. (DN 68, p. 1:21 fn. 3.)

Appellants Albert L. Lewis, Jr. ("Lewis"), John Lloyd ("Lloyd"), and Edward J. Fazekas ("Fazekas") are citizens of California, residents of Riverside County, and each reside in communities within the geographic boundaries served by the Valley Health System district. (DN 68, p. 2:1 fn. 5.) Hereinafter, Prime Healthcare Services, Inc., Lewis, Lloyd, and Fazekas shall collectively be referred to herein as "Appellants."

Real Party In Interest Physicians for Healthy Hospitals, Inc., is a California corporation whose sole shareholder is Physicians for Healthy Hospitals, LLC, a limited liability company. (DN 67, p. 5:9-11.)

B. Kali Chaudhuri, M.D.

Although not a party to these proceedings, Kali Chaudhuri, M.D. ("Chaudhuri") plays a key role in this case through his ownership and/or control of several entities with which Cherry and Drier had financial relationships and with the ability of Chaudhuri and PHH to affect the fortunes of Cherry, Rao, and Drier. In this regard, Chaudhuri owns and/or controls the following entities:

1. Physicians for Healthy Hospitals, LLC ("PHH LLC")

Chaudhuri was involved in the formation of PHH and has served as PHH LLC's initial manager since its formation. (DN 85, p. 64:13-14.) Chaudhuri is the only member of PHH LLC that can purchase more than 200 shares of PHH LLC and can only be removed as the manager by a vote of 90% of all members of PHH LLC. (DN 85, pp. 63:25-64:2, 64:10-12, 64:15-16.) PHH LLC is the sole shareholder of PHH, the buyer of Debtor's assets under the ASA. (DN 67, p. 5:9-11.)

2. Hemet Community Medical Group ("HCMG")

Chaudhuri owns no less than 38% of the outstanding shares of HCMG and serves as its Chairman. (DN 68, p. 36:3-4.) Chaudhuri can only be removed from HCMG's Board of Directors by a vote of 90% of the shareholders of HCMG. Since California law requires cumulative voting, Chaudhuri will always be a member of HCMG's Board of Directors. (DN 85, p. 53:24-54:5, 55:9-13.)

3. Menifee Valley Community Medical Group ("Menifee Medical Group")

Chaudhuri owns all of the outstanding stock of Menifee Medical Group and serves as its Chairman and Chief Executive Officer. (DN 68, p. 36:10-16.)

4. Temecula Valley Physicians Medical Group ("Temecula Medical Group")

Chaudhuri owns ninety percent (90%) of Temecula Medical Group and serves as its Chairman. (DN 68, p. 36:17-24.)

5. KM Strategic Management ("KM Management")

KM Management is owned by Chaudhuri and Mike Foutz. (DN 68, p. 37:3-4.)

6. Devonshire Surgical Medical Group ("Devonshire")

Chaudhuri owns one-third of Devonshire. (DN 68, p. 37:1.) In addition, Devonshire is managed by KM Management. (DN 68, p. 37:3-4.)

7. Hemet Healthcare Surgery Center ("Hemet Surgery")

Chaudhuri owns approximately one-third of Hemet Surgery. (DN 68, p. 37:10-11.) Chaudhuri is also a member of Hemet Surgery's Board of Directors. (DN 84, p. 218:1-5.)

C. Debtor's Bankruptcy

After its attempt to sell substantially all of its assets to Select Healthcare Solutions ("Select") was rejected by the voters in November 2007, Debtor filed a voluntary petition under Chapter 9 of the United States Bankruptcy Code on December 13, 2007. (DN 68, pp. 5:22-23, 6:21-22).

D. Debtor's Board of Directors

At all times after June 24, 2009, Debtor's Board of Directors consisted of Cherry, Amelia Hippert ("Hippert"), Robert O'Donnell ("O'Donnell"), Rao, Tom Wilson ("Wilson"), Glen Holmes ("Holmes"), and Drier. (DN 68, p. 8:9 fn. 20.) This appeal focuses on the conduct and the relationships of Cherry, Rao, and Drier and their votes in favor of the ASA in violation of Section 1090 which render the ASA void.

1. Cherry's Relationships with Chaudhuri

During the period of June 2009 to October 2009 when he voted on the Asset Sale Agreement, Cherry, either directly or by and through his professional corporation, William H. Cherry, M.D., Inc., had the following financial relationships with Chaudhuri:

(a) HCMG/Chaudhuri

During the period of June 2009 to October 2009, Cherry received compensation of no less than $10,000 from HCMG in return for serving as the

"Medical Director" for Temecula Medical Group under the terms of a contract which could be terminated by HCMG. (DN 67, p. 8:23-26.) As noted above, Chaudhuri owns 38% of HCMG and 90% of Temecula Medical Group and serves as Chairman of both HCMG and Temecula Medical Group. (DN 68, pp. 36:3-4, 36:17-24.)

(b) Menifee Medical Group/Chaudhuri

In addition to serving as a "Medical Director" for HCMG, Cherry also received compensation of no less than $10,000 from Menifee Medical Group for serving as a "Medical Director" during the period of June 2009 to August 2009. (DN 67, pp. 18:26-19:2.)

(c) KM Strategic Management/Chaudhuri

In addition to relying on HCMG and Chaudhuri for compensation as a "Medical Director" for Temecula Medical Group and Menifee Medical Group, Cherry also relied on Chaudhuri's KM Management to provide the office manager and front and back office staff for his medical practice, William H. Cherry, M.D., Inc. (DN 84, pp. 175:12-19, 177:3-5.)

2. Rao's Relationships with Chaudhuri

During the period of June 2009 to October 2009, Rao was the Administrator of Hemet Surgery, an entity in which Chaudhuri had a one-third interest. (DN 68, pp. 37:10-11, 39:13-14.)

3. Drier's Relationships with Chaudhuri

Drier is married to Dr. Ralph Drier ("Dr. Drier"), a physician who practices within the boundaries of the VHS district. During the period of June 2009 to October 2009 when she voted on the Exclusive Negotiation Agreement, the Term Sheet, and the ASA, Dr. Drier had a financial relationship with Chaudhuri/Devonshire which resulted in payments of no less than $25,000 per month to the Driers. In particular, the Driers reached an agreement in 2004 with

Chaudhuri which called for the Driers to receive $20,000 per month from Chaudhuri through Devonshire in return for Dr. Drier agreeing to no longer criticize Chaudhuri, HCMG, and KM Management and instead to support Chaudhuri's efforts. (DN 84, pp. 62:22-63:1, 65:3-10, 66:9-12, 67:7-17, 69:8-9.) In 2007, the monthly fee received by the Driers for Dr. Drier's silence was increased to $25,000 per month and remained at $25,000 through at least October 2009. (DN 84, p. 69:17-70:4.)

E. Physicians for Healthy Hospitals, Inc. ("PHH")

Physicians for Healthy Hospitals, Inc., is a Delaware corporation, which was formed in July 2009. (DN 67, p. 5:9-11.). PHH is wholly owned by PHH, LLC. *Id.*

F. The Exclusive Negotiation Agreement

On July 24, 2009, PHH contacted Debtor regarding an interest in acquiring substantially all of Debtor's assets. (DN 68, p. 9:8-9.) At the same time, PHH requested that Debtor enter into an agreement which would give PHH the exclusive right to negotiate with Debtor for a period of ninety (90) days (the "Exclusive Negotiation Agreement"). (DN 68, p. 9:9-11.) On July 27, 2009, less than three (3) days after PHH first contacted Debtor, Debtor's Board of Directors voted 5-2 to enter into the Exclusive Negotiation with PHH. (DN 68, p. 9:14-16.) Even though they had conflicts of interest under Section 1090, Cherry, Rao, and Drier participated in the vote and were among the five (5) board members who voted for the Exclusive Negotiation Agreement. (DN 68, p. 9:14-15.)

G. The Memorandum of Understanding & Term Sheet

On September 15, 2009, the Debtor posted public notice that its Board of Directors would meet one day later on September 16, 2009 to consider, among other things, the approval of a memorandum of understanding and term sheet ("MOU") with PHH regarding the sale of Debtor's assets. (DN 68, p.10:2-5.) The

MOU called for PHH to acquire substantially all of Debtor's assets. (DN 68, p. 10:2-5.) On September 16, 2009, Debtor's Board of Directors vote 6-1 to approve MOU. (DN 68, p. 10:5-9.) Again, even though they had conflicts of interest under Section 1090, Cherry, Rao, and Drier voted in favor of the MOU. (DN 68, p. 10:5-9.)

H. The Asset Sale Agreement

On October 5, 2009, the Debtor posted public notice that its Board of Directors would meet one day later on October 6, 2009 to consider possible action to approve an Asset Sale Agreement ("ASA") with PHH. (DN 68, p. 12:2-3.) On October 6, 2009, Debtor's Board of Directors voted 6-1 to approve the ASA. (DN 68, p. 12:3-5.) Like the MOU, the ASA called for PHH to acquire substantially all of Debtor's assets. The consideration to be paid by PHH in exchange for all of Debtor's assets included cash as well as the resolution/compromise/withdraw of bankruptcy claims submitted by KM Management, HCMG, and Menifee Medical Group. (DN 68, p. 12:14 fn 32.) Both KM Management and HCMG had a financial interest in the ASA as their bankruptcy claims would be affected by the ASA. *Id.* Even though they had conflicts of interest under Section 1090, Cherry, Rao, and Drier were among the six (6) board members who voted to approve the ASA. (DN 68, p. 12:5-6). The ASA was executed on October 14, 2009. (DN 68, p. 12:6).

I. The Challenge Actions

On and after October 6, 2009, Appellants filed a number of actions challenging the actions of Debtor and its Board of Directors and the ASA including an action seeking an order declaring that the ASA was void based on violations of Section 1090 by Cherry, Rao, and Drier.[3] In particular, on October 13, 2009,

[3] Appellants also filed actions related to Debtor's proposed ballot language, Debtor's failure to release public records, and Debtor's failure to comply with the California Environmental Quality Act. Since this appeal is not based on such actions, Appellant does not discuss such actions herein.

Appellants filed a motion seeking relief from the automatic stay to file a complaint for injunctive and declaratory relief to obtain an order voiding the ASA based on, among other things, violations of Section 1090 by Cherry, Rao, and Drier ("Section 1090 Action"). (DN 68, p. 15:4-12.)

On November 12, 2009, the Bankruptcy Court denied Appellants request for relief from the automatic stay. (DN 68, p. 15:17-19). Before the Bankruptcy Court entered its November 23, 2009 order denying Appellants' request for relief from automatic stay, Appellants filed a renewed motion for relief from automatic stay seeking, among other things, relief to commence the Section 1090 Action. (the "Renewed Motion") (DN 68, pp. 15:19-16:1). On November 30, 2009, the Bankruptcy Court denied Appellants' request for an expedited hearing on the Renewed Motion. (DN 68, p. 16:1-3.)

On December 7, 2009, Appellants filed a notice of appeal with respect to the Bankruptcy Court's November 23, 2009 order denying their request for relief from stay to pursue the Section 1090 Action. (DN 68, p. 16:1-3.)

J. Submission of Section 1090 Action To Jurisdiction of Bankruptcy Court.

On January 20, 2010, Appellants, Debtor, and PHH filed a stipulation with the Bankruptcy Court which, among other things, provided that Appellants would withdraw the Renewed Motion and their appeal of the November 23, 2009 order denying relief from stay and that the Bankruptcy Court would have jurisdiction to adjudicate Appellants' claim that the ASA was void under Section 1092 based on violations of Section 1090 by certain members of Debtor's Board of Directors in conjunction with confirmation of Debtor's Plan. (DN 68, p. 16:6-11). On January 22, 2010, the Bankruptcy Court entered an order approving the parties stipulation. (DN 68, pp. 16:11-17:1).

K. Debtor's Plan

On November 2, 2009, Debtor filed a disclosure statement and proposed plan of adjustment which is predicated upon Debtor selling substantially all of its assets to PHH under the ASA.[4] (DN 68, p. 12:7-8). Debtor cannot consummate its plan of adjustment if the ASA is void under Section 1092.

L. The Confirmation Hearing

On February 9, 2010, the Bankruptcy Court commenced a hearing on confirmation of Debtor's Plan. (DN 69, p. 17:6-7). At the February 9, 2010 hearing, the Bankruptcy Court overruled certain objections raised by Appellants and continued the hearing until February 22, 2010 for an evidentiary hearing with respect to, among other things, Appellants' Section 1090 Action. (DN 68, pp. 17:6-18:6.)

On February 22, 2010 and continuing through February 26, 2010, the Bankruptcy Court received evidence regarding the Section 1090 Action. (DN 68, pp. 19:1-20:6). At the conclusion of the hearing on February 26, 2010, the Bankruptcy Court took the matter under submission. (DN 68, p. 20:6-7).

M. The Memorandum Decision

On April 8, 2010, the Bankruptcy Court issued a Memorandum Decision regarding the confirmation of Debtor's Plan and the adjudication of the challenge actions. (DN 68). In its decision, the Bankruptcy Court concluded (albeit incorrectly) that the ASA was not void under Section 1092 because: (1) there was no credible evidence that Cherry, Rao, or Drier were unduly influenced by Chaudhuri; (2) that there was no evidence that Chaudhuri or any other individual directed Cherry, Rao, and Drier how to vote on the ASA and/or promised Cherry, Rao, and Drier consideration in exchange for a favorable vote on the ASA; and (3) that the financial relationships between Cherry, Rao, and Drier and PHH,

[4] Appellants are informed and believe that Debtor and PHH have yet to complete the transaction called for by the ASA.

Chaudhuri, and others were too remote and speculative to result in a violation of Section 1090. (DN 68.)

N. The Confirmation Order

On April 26, 2010, the Bankruptcy Court entered an order confirming Debtor's Plan and rendering judgment in favor of Debtor as to the Challenge Actions. (DN 69.)

O. The Appeal

On May 6, 2010, Appellants filed a notice of appeal as to the Confirmation Order. (DN 70).

V

STANDARD OF REVIEW

When considering an appeal from the bankruptcy court, a district court uses the same standard of review that a circuit court would use in reviewing a decision of the district court. *In re Baroff*, 105 F.3d 439, 441 (9th Cir. 1997). District court decisions which are based on a mixed question of law and facts are subject to de novo review when the application of law to facts will require the consideration of legal concepts and involve the exercise of judgment about the values underlying the legal principles. *Ralls v. U.S.*, 52 F.3d 223, 227 (9th Cir. 1995). In this case, the facts were largely undisputed and those portions of the Bankruptcy Court Order which are the subject of this appeal turn on the Bankruptcy Court's application of Section 1090 to these facts while exercising judgment about the values underlying Section 1090. As such, a de novo review is appropriate in this case. *Id.*

VI

ARGUMENT

The Bankruptcy Court erred when it issued the Confirmation Order and the Confirmation Order must be reversed because: (1) Debtor's Plan is only feasible if the ASA is not void under Section 1092; (2) the ASA is void under Section 1092 because Cherry, Rao, and Drier violated Section 1090 when they voted to approve the ASA; and (3) since the ASA is void under Section 1092, Debtor's Plan is not feasible.

A. Debtor's Plan Is Only Feasible If The ASA Is Not Void Under Section 1092.

A plan of adjustment is not feasible if it requires the debtor to take an action necessary to carry out the plan which is prohibited by law. *See 11 U.S.C. § 943(b)*. Debtor's Plan is predicated on and can only be carried out if the transactions contemplated by the ASA are consummated. (DN 68, p. 12:7-8.) As such, if the ASA is void under Section 1092, Debtor's Plan is not feasible . *See 11 U.S.C. § 943(b)*.

B. The ASA Is Void Since Cherry, Rao, and Drier Voted To Approve It Despite Being Prohibited From Doing So By Section 1090.

Every contract made in violation of Section 1090 is void. *See Gov't Code* § 1092; *Marin Healthcare Dist. V. Sutter*, 103 Cal.App.4th 861, 877 (2002). Section 1090 specifically addresses conflicts of interest in the contract making process and prevents state, county, district, and city officers or employees from being "financially interested in any contract made by them in their official capacity, or by any body or board of which they are members." *Gov't Code*, § 1090. If an official is a member of a board that actually executes or approves the contract, he or she is conclusively presumed to be involved in the making of his or her agency's contract. *Thomson v. Call*, 38 Cal.3d 633, 649 (1985). A director of a hospital

district like the members of Debtor's Board of Directors are subject to the prohibition against participating in a transaction in which he or she is financially interested. *See Eldridge v. Sierra View Local Hospital Dist.*, 224 Cal.App.3d 311, 320 (1990).

The object of Section 1090 is to remove or limit the possibility of any personal influence, either directly or indirectly, which might bear on an official's decision. *People v. Gnass*, 101 Cal.App.4th 1271, 1298 (2002). The evil to be thwarted by Section 1090 is easily identified: If a public official is pulled in one direction by his financial interest and in another direction by his official duties, his judgment cannot and should not be trusted, even if he attempts impartiality. *Carson Redevelopment Agency v. Padilla*, 140 Cal.App.4th 1323, 1330 (2006). Indeed, Section 1090 is more concerned about what might have happened then what actually happened. *Carson Redevelopment Agency v. Padilla*, 140 Cal.App.4th at 1330; *People v. Honig*, 48 Cal.App.4th 289, 314 (1996). Section 1090 is concerned with any interest, other than perhaps a remote or minimal interest, which would prevent the official involved from exercising absolute loyalty and undivided allegiance to the best interests of the public entity. *People v. Honig*, 48 Cal.App.4th at 315. In this regard, courts have continually reiterated that no matter how "devious and winding the trail may be which connects the officer to the forbidden contract," if a connection can be made, a violation of Section 1090 will be found. *Id.* For example, in *People v. Gnass*, the court found that the possibility that an agency created by the city for which the defendant served as city attorney and a third party with which the defendant had no connection, might select the defendant's law firm to serve as counsel for a portion of a bond measure to be issued by the new agency was sufficient to create a conflict of interest under Section 1090. *People v. Gnass*, 101 Cal.App.4th 1271, 1300 (2002).

In interpreting Section 1090, California courts have relied on the United States Supreme Court's decision in *U.S. v. Mississippi Valley Generating Co.*, 364 U.S. 520 (1961) for guidance. *People v. Gnass*, 101 Cal.App.4th at 1300. In *Mississippi Valley*, the Supreme Court held that because the sponsors of a proposed contract were in a position to affect the fortune of the public official, the official was to say the least, subconsciously tempted to ingratiate himself with the sponsors and accede to their demands and thus a violation of the federal equivalent of Section 1090 had occurred. *U.S. v. Mississippi Valley Generating Co.*, 364 U.S, 520, 557 (1961).

In this case, the ASA was made in violation of Section 1090 and is thus void under Section 1092 because: (1) Cherry and Drier were prohibited by Section 1090 from voting on the ASA because they had financial relationships with HCMG and KM Management and HCMG and KM Management had a financial interest in the ASA; (2) Cherry, Rao, and Drier were prohibited by Section 1090 from voting on the ASA because Chaudhuri, the sponsor of the ASA, was in a position to affect the fortunes of Cherry, Rao, and Drier; (3) Cherry, Rao, and Drier voted to approve the ASA despite being prohibited from doing so by Section 1090; and (4) a violation of Section 1090 may be established without evidence that the public official was actually influenced or promised consideration for a favorable vote.

1. Cherry and Drier Were Prohibited By Section 1090 From Voting On The ASA Because They Had Financial Relationships With HCMG and KM Management and HCMG and KM Management Had A Financial Interest In The ASA.

Cherry and Drier were prohibited by Section 1090 from voting on the ASA because they had financial relationships with HCMG and KM Management at the time they voted on the ASA and HCMG and KM Management had a financial interest in the ASA. First, HCMG and KM Management filed claims in Debtor's

bankruptcy in which they claimed they were owed money by Debtor. (DN 68, p. 12:14 fn. 32.) The ASA, which was approved by Cherry and Drier on October 6, 2009, values the claims of HCMG and KM Management along with claims by two other Chaudhuri controlled entities to be worth $55 Million, calls for PHH to assume liability for these claims, and treats PHH's assumption of liability as part of the consideration to be paid for Debtor's assets. (DN 68, p. 12:10-14.) In other words, HCMG's and KM Management's assets are part of the consideration to be paid by PHH under the ASA. Thus, HCMG and KM Management have a financial interest in the ASA.

In addition, Cherry and Drier had financial relationships with HCMG and KM Management when they voted to approve the ASA. Cherry received monthly payments from HCMG to serve as a "Medical Director" for Temecula Medical Group and Menifee Medical Group. (DN 67, p. 8:23-26.) At the same time, KM Management also provided an office manager and other office staff to Cherry's medical practice. (DN 84, p. 175:12-19, 177:3-5.) Like Cherry, Drier also had financial relationships with HCMG and KM Management. Dr. Drier, Drier's husband, received referrals from HCMG and the Driers received $25,000 per month from Devonshire, which was managed by KM Management, to no longer criticize HCMG and Chaudhuri and instead support HCMG and Chaudhuri. (DN 84, pp. 62:22-63:1, 65:3-10, 66:9-12, 67:7-17, 69:8-9, 69:17-70:4.) Indeed, it was Mike Foutz, Chaudhuri's partner in KM Management and an investor in PHH, that increased the Drier's monthly payment from $20,000 to $25,000. (DN 84, p. 69:17-70:4.)

HCMG's and KM Management's interest in the ASA and Cherry's and Drier's financial relationships with HCMG and KM Management are more than sufficient to create a conflict of interest under Section 1090 which prohibited Cherry and Drier from voting on the ASA. *Gov't Code*, §§ 1090. This is

especially true since Cherry admitted that his relationship with HCMG was sufficient to require recusal when Debtor's Board of Directors were considering a sale of Debtor's assets to Select Healthcare.

2. Cherry, Rao, and Drier Were Prohibited By Section 1090 From Voting On The ASA Because The Sponsors Of The ASA Had The Ability To Affect Their Fortunes.

As noted above, California courts have relied on *U.S. v. Mississippi Valley Generating Co.*, 364 U.S. 520, 557 (1961) in order to interpret Section 1090. *People v. Gnass*, 101 Cal.App.4th at 1300. In *Mississippi Valley*, Adolph Wenzell ("Wenzell") undertook to advise the federal government and act on its behalf in negotiations which culminated in a contract between the federal government and Mississippi Valley Generating Company ("MVG") for the construction of a power plant in Memphis, Tennessee. *U.S. v. Mississippi Valley Generating Co.*, 364 U.S. 520, 524 (1961). Wenzell was not a shareholder or employee of MVG, but instead was employed by First Boston Corporation. *Id.* at 523. After MVG sued the federal government for breach of contract, the federal government claimed that the contract with MVG was void under federal conflict of interest statutes because Wenzell worked for First Boston and it was apparent that First Boston was likely to receive benefit from the contract by financing the construction of the power plant. *Id.* In finding that Wenzell did in fact have a conflict of interest even though he had no interest in MVG, the Supreme Court held that the proper test to determine whether Wenzell had a conflict of interest was whether MVG, as the sponsor of the project, had the ability to affect the fortunes of Wenzell. Applying this test, the Supreme Court held that Wenzell had a conflict of interest because MVG was in a position to affect the futures of Wenzell or his firm, Wenzell was to say the least, subconsciously tempted to ingratiate himself with MVG and accede to their demands. *Id.* at 557. In this case, much like MVG in the *Mississippi*

Valley case, the sponsors of the ASA (PHH and Chaudhuri) were in a position to affect the fortunes of Cherry, Rao, and Drier such that Cherry, Rao, and Drier violated Section 1090 when they voted to approve the ASA.[5]

(a) Cherry

Chaudhuri owns and/or controls HCMG and KM Management. HCMG paid Cherry to serve as a "Medical Director" for Temecula Medical Group, which is owned by Chaudhuri, and Menifee Medical Group, which is also owned by Chaudhuri. (DN 67, p. 8:23-26.) Based on his ownership interests as well as his membership on HCMG's Board of Directors and his role as Chairman of HCMG, Menifee Medical Group, and Temecula Medical Group, Chaudhuri had the ability to terminate these relationships and/or increase the financial value of these relationships to Cherry. No payments from HCMG or an increase in payments from HCMG would certainly affect Cherry's fortunes. Therefore, Cherry had a conflict of interest when he voted on the ASA. *Gov't Code*, § 1090; *U.S. v. Mississippi Valley Generating Co.*, 364 U.S. at 557.

In addition to monthly payments from HCMG, Cherry also relies on KM Management to manage his medical practice by providing an office manager and other staff for his medical practice. (DN 84, p. 175:12-19, 177:3-5.) As the owner of KM Management, Chaudhuri had the ability to stop providing practice management employees to Cherry which would certainly affect his fortunes. Thus, Chaudhuri, by and through KM Management, had the ability to affect Cherry's fortunes and as a result, Cherry had a conflict of interest when he voted on the

[5] In the Decision, the Bankruptcy Court relied on *J.M. Hotchkiss v. J.J. Moran*, 109 Cal.App. 3, 21 (1930) as support for its conclusion that Cherry, Rao, and Drier did not violate Section 1090 when they voted to approve the ASA. The Bankruptcy Court's reliance on Hotchkiss is misplaced. First, unlike Hotchkiss, Appellants' claims are based on much more than Chaudhuri being a shareholder of PHH and entities with which Cherry, Rao, and Drier have a financial relationship. Rather, Appellants' claims are based on HCMG's and KM Management's financial interest in the ASA and Cherry and Drier's relationships with HCMG and KM Management and Chaudhuri's ability to affect the fortunes of Cherry, Rao, and Drier as a result of his control over HCMG, KM Management, and Devonshire. In addition, unlike the respondent in *Hotchkiss*, PHH is not the only entity that could acquire Debtor's assets.

ASA on October 6, 2009. *Gov't Code*, § 1090; *U.S. v. Mississippi Valley Generating Co.*, 364 U.S. at 557.

(b) Rao

Chaudhuri owns one-third of Hemet Surgery, Rao's employer. (DN 68, pp. 37:10-11, 39:13-14.) As a one-third owner of Hemet Surgery, Chaudhuri would have the ability to affect Rao's fortunes by, among other things, recommending a salary increase, recommending a salary decrease, recommending a bonus, and/or recommending that Rao's employment be terminated. As such, Rao had a conflict of interest under Section 1090. *Gov't Code*, § 1090; *U.S. v. Mississippi Valley Generating Co.*, 364 U.S. at 557.

(c) Drier

At all relevant times, Chaudhuri owned and/or controlled HCMG, KM Management, and Devonshire. In addition, KM Management managed the operations of Devonshire. At the same time, Dr. Drier, Drier's husband, received referrals from HCMG and the Driers received no less than $25,000 per month from Chaudhuri, by and through Devonshire, in exchange for Dr. Drier's agreement to no longer criticize Chaudhuri and HCMG and instead to support them. The agreement to pay the Driers $25,000 for Dr. Drier's support was negotiated and controlled by Chaudhuri and KM Management. For example, Chaudhuri attended the initial meeting where the agreement was reached and Mike Foutz, Chaudhuri's partner in KM Management and an investor in PHH, approved the Driers' request for an increase from $20,000 to $25,000 per month. (DN 84, pp. 62:22-63:1, 65:3-10, 66:9-12, 67:7-17, 69:8-9, 69:17-70:4.) Chaudhuri had the ability to stop the payments of $25,000 per month to the Driers and there is no question that a loss of $25,000 per month would affect the fortunes of any person, much less the Driers. Therefore, Chaudhuri had the ability to effect the fortunes of Drier and Drier thus

had a conflict of interest under Section 1090. *Gov't Code*, § 1090; *U.S. v. Mississippi Valley Generating Co.*, 364 U.S. at 557.

3. The ASA Is Void Because Cherry, Rao, and Drier Voted To Approve The ASA Despite Being Prohibited From Doing So By Section 1090.

Every contract made in violation of Section 1090 is void. *See Gov't Code* § 1092; *Marin Healthcare Dist. V. Sutter*, 103 Cal.App.4th at 877. A board member who approves the contract is conclusively presumed to be involved in the making of the contract. *Thomson v. Call*, 38 Cal.3d at 649. As discussed above, Cherry, Rao, and Drier were prohibited by Section 1090 from voting on the ASA under Section 1090 because they were financially interested in the ASA. Nonetheless, Cherry, Rao, and Drier all voted to approve the ASA. (DN 68, p. 12:5-6.) As such, the ASA was made in violation of Section 1090 and is void under Section 1092. *See Gov't Code* § 1092; *Marin Healthcare Dist. V. Sutter*, 103 Cal.App.4th at 877.

4. A Violation Of Section 1090 May Be Established Without Evidence That The Public Official Was Actually Influenced Or Promised Consideration For A Favorable Vote.

In its April 8, 2010 Memorandum Decision, the Bankruptcy Court seems to suggest that Appellants were required to establish that Cherry, Rao, and/or Drier were either unduly influenced, were directed to vote in a certain manner, or were promised consideration in return for a favorable vote on the ASA to establish a violation of Section 1090. To the extent the Bankruptcy Court's decision was based on Appellants failure to produce evidence in this regard, it constitutes error because Section 1090 is more concerned about what might have happened then what actually happened. *See Carson Redevelopment Agency v. Padilla*, 140 Cal.App.4th at 1330; *People v. Honig*, 48 Cal.App.4th at 314.

C. Since The ASA Is Void Under Section 1092, The Plan Is Not Feasible And The Confirmation Order Must Be Reversed.

As discussed above, Debtor Plan is predicated on and can only be carried out if the transactions contemplated by the ASA are consummated. Since the ASA is void under Section 1092, the transactions contemplated by the ASA cannot be consummated and Debtor's Plan is not feasible. *See 11 U.S.C. § 943(b)*. As such, the Confirmation Order must be reversed.

VII

CONCLUSION

For the foregoing reasons, Appellants request that their appeal be granted and that this Court enter the Confirmation Order be reversed and the ASA declared void under Section 1092.

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Dated: October 13, 2010

By: /s/ Michael J. Sarrao
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